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In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 764

BURR OAKS CORPORATION, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioner Burr Oaks Corporation was organized for the purpose of developing, subdividing and selling improved lots from a parcel of land owned by petitioners Elkind, Watkins and Ritz (Pet. 35).[1] The corporation's common stock was issued (for a total of $4,500 in cash) one-third each to the wives of Elkind and Watkins and one-third to two brothers of Ritz (Pet. 36). Shortly thereafter Elkind, Watkins and Ritz transferred their land to the corporation. Although the land had a fair market value of not more

[1] The individual petitioner's wives are parties only because they filed joint returns with their husbands for the years in question.

than $165,000, the corporation gave Elkind, Watkins and Ritz 6 percent promissory notes in the total amount of $330,000 (each receiving a $110,000 note) (Pet. 37–38).

Elkind, Watkins and Ritz completely dominated the corporation's affairs, and, without the knowledge of the holders of the common stock or the board of directors, the corporation made transfers of part of the land back to them without charge or for less than would have been realized from sales to third parties (Pet. 38–40). Elkind, Watkins and Ritz received $64,000 apiece during the years 1959–1961, as installment payments on the notes (Pet. 41–42). The corporation has never distributed anything to its common stockholders (Pet. 42). The Tax Court concluded that Elkind, Watkins and Ritz never had any intention of enforcing the notes against the corporation but placed their land at the risk of the business, using the notes only to obtain a continuing interest in the corporation that would enable them to withdraw from the corporation the developer's profit normally inherent in the subdivision and sale of such land (Pet. 38, 42, 46).

If the transaction had the tax effect hoped for by petitioners, (1) the corporation would have been able to use the inflated purchase price as its cost basis in the land, eliminating substantially all of its profit on the sale of the lots and minimizing its income tax liabilities, and (2) Elkind, Watkins and Ritz would have obtained capital gain treatment on the difference between the purported selling price to the corporation and their original cost basis in the land.

Both courts below, however, agreeing with the Commissioner, concluded that in reality Elkind, Watkins and Ritz had made an equity investment in the corporation to the extent of the land which they transferred to it and that the promissory notes which they received in exchange for the land constituted, in substance, preferred stock in the corporation. Consequently, the unified transaction whereby Elkind, Watkins, Ritz and their relatives transferred the land and $4,500 cash to the corporation upon its organization constituted an exchange of property for stock within the purview of § 351(a) of the 1954 Code, and the corporation's basis in the land was the same as the basis which it had in the hands of the transferors. 1954 Code § 362(a). Thus, the payments by the corporation to Elkind, Watkins and Ritz constituted, not payments on indebtedness, but proportional redemptions of preferred stock, taxable to them as dividend income under § 302(d) to the extent of the corporation's earnings and profits. (Pet. 21–56.)

The decision below is correct, and there is no conflict of decision or other basis for further review.

Contrary to petitioner's suggestion (Pet. 18), this is not "the first case where payments on instruments which were pure debt obligations under general law principles were taxed to the recipients as dividends on stock." See, *e.g.*, *Gooding Amusement Co.* v. *Commissioner*, 236 F. 2d 159 (C.A. 6), certiorari denied, 352 U.S. 1031; *Fellinger* v. *United States*, 363 F. 2d 826 (C.A. 6). Moreover, it is well established that the form of a transaction is not determinative of whether a purported debt instrument in reality represents

genuine indebtedness or an equity investment. See, *e.g., Gilbert* v. *Commissioner,* 248 F. 2d 399 (C.A. 2); *P.M. Finance Corp.* v. *Commissioner,* 302 F. 2d 786 (C.A. 3); *Aronov Construction Co.* v. *United States,* 223 F. Supp. 175 (M.D. Ala.), affirmed, 338 F. 2d 337 (C.A. 5); *Arlington Park Jockey Club* v. *Sauber,* 262 F. 2d 902 (C.A. 7); *Gooding Amusement Co.* v. *Commissioner, supra.* As the lower courts found, the transfer of the land to the corporation by Elkind, Watkins and Ritz had all of the characteristics of an equity investment.

The principal thrust of petitioners' argument, however, is that *Commissioner* v. *Brown,* 380 U.S. 563, tacitly abolished the fundamental proposition that a transaction may be treated differently in the practical reference of federal income taxation than state law and the labels selected by the parties would suggest. In *Brown,* this Court merely held that when property is disposed of at a reasonable price in arm's-length dealing to a buyer who is not controlled by the seller, the transaction constitutes a "sale" even though the purchase price is collectible only out of the property transferred and its profits. To be sure, in reaching that result, this Court noted that the transaction there involved was a "sale" under general law (p. 571), but that was the beginning of the inquiry, not the end of it. The instant case did not involve arm's-length bargaining, the purchase price was more than twice the fair market value of the property transferred, and the transferors controlled the transferee. Moreover, the question in the present case is whether the purported

"notes" actually constitute equity interests so that § 351 will apply. Finally, it is clear that *Brown* did not overrule *sub silentio* all of the tax decisions in the equity-versus-debt area holding that the substance of the transaction controls and substitute instead a mechanical reference to the labels chosen by the parties as viewed under state law.

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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